

Related Party Transactions Audit and Appraiser Requirements

21 March 2018

EAD Regulation Development Team



Outline

- Key audit aspects of the new rules
- What independent auditors should be looking for
- Impact of a modified audit opinion on information disclosure
- Our independent appraiser expectations
- Auditor and appraiser questions
- Opportunity for discussion



Audit aspects of the new rules (1)

Closer linking of assurance standards with ID requirements

- We have incorporated assurance standards ISAE (NZ) 3000 and SAE 3100 into the ID determination by reference for all aspects of the ID disclosure requirements - see ID clause 2.8.1(1) and Attachment D of the Reasons paper



Audit aspects of the new rules (2)

Auditor opinion on material compliance

- For ID reporting on related party transactions, an assurance report by the independent auditor must in all cases state whether *in the auditors opinion* the basis of valuation of related party transactions has complied *in all material respects* with the related party arm's-length valuation rule (ID clause 2.8.1(1)(d)):
 - Capex – see IM clauses 2.2.11(1)(g) and 2.2.11(5)
 - Opex and sales – see ID clause 2.3.6



Audit aspects of the new rules (3)

Principles-based valuation approach

- The auditor will need to ensure that the regulated business has completed its valuations in accordance with the principles-based approach (ID clauses 2.8.1(1)(d) & 2.3.6 and IM clauses 2.2.11(1)(g) & 2.2.11(5)):
 - Each acquisition is valued at no greater than if it had the terms of an arm's-length transaction
 - The value of the good or service does not exceed the actual amount charged to the regulated business by the related party
 - A sale or supply to a related party is valued at no less than if it had the terms of an arm's-length transaction



Audit aspects of the new rules (4)

Better alignment with accounting standards

- To better align our requirements with accounting standards we have also referenced the definition of “related party” in NZ IAS 24 and have provided guidance that “arm’s-length transaction” has the same meaning as for ISA (NZ) 550¹

¹ External Reporting Board (XRB) “International standard on auditing (New Zealand) 550 - Related Parties (ISA (NZ) 550).” Compiled November 2016 and incorporating amendments up to and including October 2016.



Audit aspects of the new rules (5)

Exercise of auditor judgement

- An objective and independent measure of valuation must be used by the regulated supplier (ID clause 2.3.6(3) and IM clause 2.2.11(5)(b))
- We expect independent auditors to exercise professional judgement in accordance with the assurance standards: see paragraphs 4.35 to 4.45 of the Reasons paper



Audit aspects of the new rules (6)

Modified opinion is a possible outcome

- If the independent auditor concludes that a modified audit opinion is appropriate, we have provided guidance: see paragraph 4.42 of the Reasons paper and clause 2.8.2(3) of the ID determinations



Audit aspects of the new rules (7)

The consolidation option

- Where a transaction is valued for ID disclosure purposes at the cost normally incurred by the related party, and provided this is fair and reasonable to the regulated supplier, for simplicity this may be treated as if it was an arm's-length transaction (IM clause 2.2.11(6) and ID clause 2.3.7)



Audit aspects of the new rules (8)

Reporting of key audit matters (new feature)

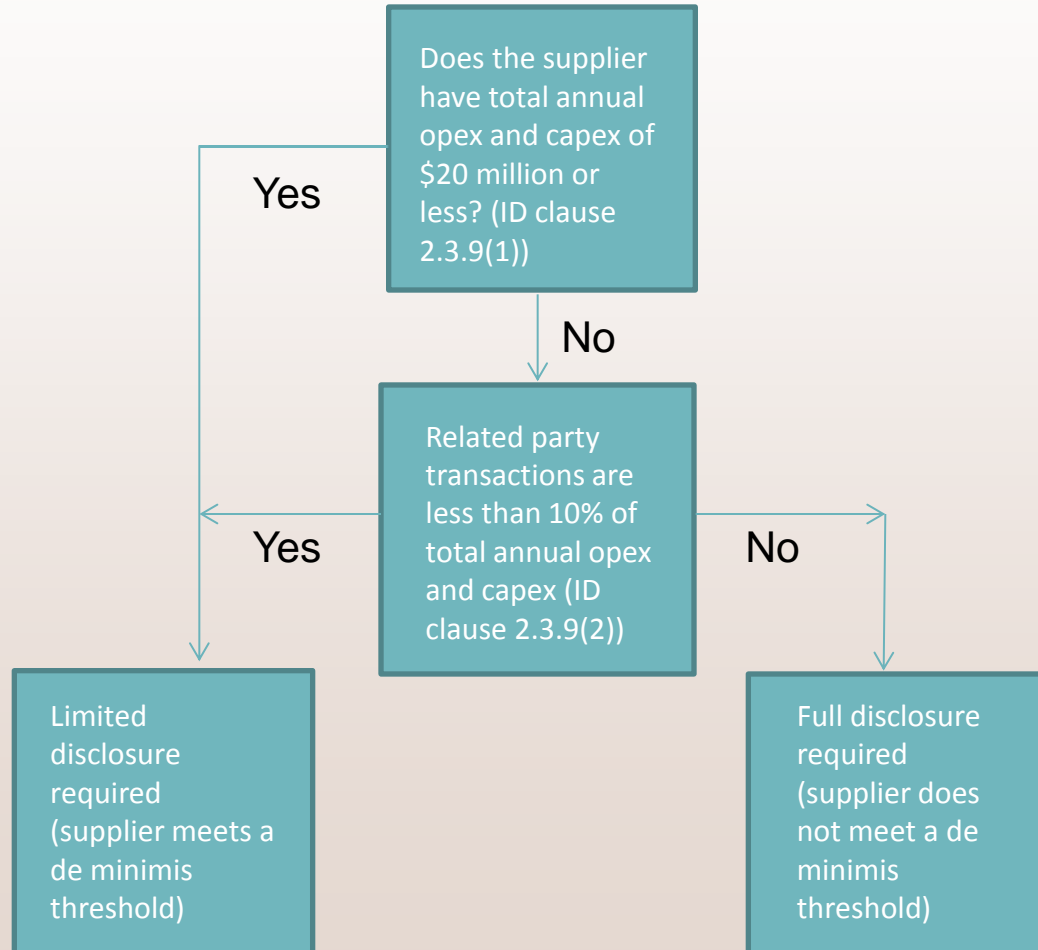
- An assurance report by the independent auditor must in all cases state *any key audit matters* relating to all aspects of the ID assurance report (ie, not just for related party transactions):²
 - selected from matters reported by the auditor to the Board
 - require significant management judgement relating to the ID disclosures
 - reflect a higher risk of material ID misstatement, require significant auditor attention and have a significant effect on how the assurance engagement is carried out

²see full requirements in ID clause 2.8.1 (2)



What independent auditors should be looking for (1)

Has the business applied the right set of related party transactions disclosure rules?



What independent auditors should be looking for (2)

Full and limited disclosures

Requirement	Full disclosure (do not meet a de minimis threshold)	Limited disclosure (meet a de minimis threshold)
Related party relationships	✓	✓
Procurement policies and processes	✓	X
Practical application of the procurement policies and processes	✓	X
Recent examples of market testing	✓	X
Map of anticipated network expenditure and network constraints	✓	X
Valuation methodology	✓	✓
Report on Related Party Transactions (Schedule 5b) ¹	✓	✓
Audit and assurance requirements	✓	✓
Independent report	✓	X



What independent auditors should be looking for (3)

Requirements of limited disclosure

- Where a regulated supplier must make a *limited disclosure*, the auditor must state whether the supplier has complied, *in all material respects*, with our requirements to apply the arm's-length valuation rule and disclose related party transactions “audited disclosure information”:
 - a diagram or a description showing the connection between the regulated supplier and the related party (ID clause 2.3.8)
 - a report on related party transactions (ID schedule 5b)



What independent auditors should be looking for (4)

Requirements of full disclosure

- Where a regulated supplier must make a *full disclosure*, the auditor must state whether the supplier has complied, *in all material respects*, with our requirements to apply the arm’s-length valuation rule and disclose related party transactions “audited disclosure information”:
 - a diagram or a description showing the connection between the regulated supplier and the related party (ID clause 2.3.8)
 - summary procurement policy information (ID clause 2.3.10)
- (continued next page)



What independent auditors should be looking for (5)

Requirements of full disclosure (continued)

- practical application of procurement policies and processes (ID clause 2.3.12(1))
- detailed procurement policy information *to be provided to the Commission by the regulated supplier* (ID clause 2.3.11)
- recent examples of market testing (ID clause 2.3.12(3) to (5))
- a report on related party transactions (ID schedule 5b)

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What independent auditors should be looking for (6)

Requirements of full disclosure (continued)

- a description of any policies or procedures that require or have the effect of requiring a consumer to purchase from a related party items related to the supply of the regulated service (ID clause 2.3.12(2))



What independent auditors should be looking for (7)

No assurance opinion on the heat map

- The independent auditor is *not* required to provide assurance on the map of anticipated network expenditure and network constraints (ID clause 2.3.13 to 2.3.16)



Impact of modified opinion on information disclosure (1)

Guidance on modified opinions

- If the independent auditor concludes that a modified assurance opinion is appropriate in the case of a full disclosure, we have provided guidance - see paragraph 4.42 of the reasons paper and ID clause 2.8.2(3):
 - Where the auditor is not able to conclude that the valuation of transactions complies in all material respects with the arm's-length valuation rule under full disclosure, this leads to a requirement for the regulated supplier to obtain an independent report (ID clause 2.8.2(3))

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Impact of modified opinion on information disclosure (2)

Guidance on modified opinions (continued)

- The auditor should not feel under additional time pressure to conclude on the assurance opinion for the related party transactions disclosures
- We have allowed for the independent report to be done in the next year if necessary (ID clause 2.8.3)
- In that case, the regulated supplier must disclose a statement of its intention to procure an independent report in the subsequent year



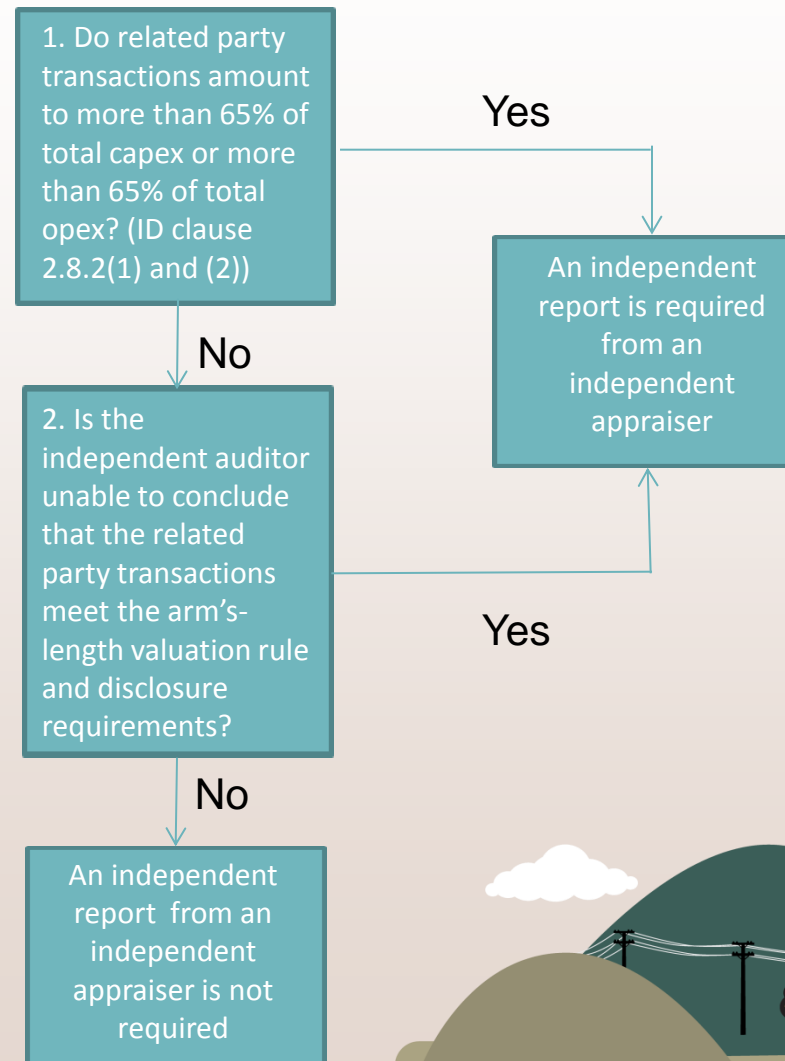
Impact of modified opinion on information disclosure (3)

Consequences of modified opinions

- If a regulated supplier persistently receives a modified assurance opinion in respect of application of the arm's-length valuation rule, this would each time trigger the requirement for an independent report from an independent appraiser
- Although the rule on how often an independent report must be obtained has some relief provisions, if each required independent report also reflects an equivalent modified opinion, the Commission will consider its other regulatory compliance enforcement options



Our independent appraiser expectations (1)



Our independent appraiser expectations (2)

Independent report not required every year

- An independent report is not required if the regulated supplier meets the de minimis threshold (ID clause 2.3.9)
- An independent report is not required if:
 - the regulated supplier disclosed an independent report for at least one of the last two disclosure years (ID clause 2.8.5(2))
and
 - the total proportion of related party transactions in each of opex or capex (as applicable) has not increased by more than 5% since the disclosure year addressed in the most recent prior report (ID clause 2.8.5(1))



Our independent appraiser expectations (3)

Independent appraiser qualifications

- We expect the independent appraiser to be of a professional standing equivalent to the independent auditor in a field appropriate to the independent report (see also more detail of ID definition of “independent appraiser” paragraph (b))
- The independent auditor can also be the independent appraiser (ID definition of “independent appraiser” paragraph (a))
- The report must set out the qualifications of the independent appraiser to provide the opinion in the report
- We do not at this stage anticipate providing further guidance on choosing independent appraisers



Our independent appraiser expectations (4)

Independent appraiser must provide opinions

- The independent appraiser must *provide an opinion* on whether the regulated supplier's related party transactions would comply *in all material respects* with the arm's-length valuation rule, and set out the grounds for that opinion
- It must summarise the steps the regulated supplier has taken to test whether related party transactions comply with the arm's-length valuation rule and whether *in their opinion* these are considered to be *in all material respects* reasonable



Our independent appraiser expectations (5)

Independent report is separate from the assurance opinion

- The requirements for the independent report are separate from the ID assurance requirements, but the regulated supplier is free to engage the independent auditor to carry out the role of the independent appraiser (ID definition of “independent appraiser”)
- The independent report must be a separate report from the ID assurance report (ID clause 2.8.4 report requirements generally and ID clause 2.8.4(2) specifically)



Our independent appraiser expectations (6)

Modified opinion by the independent appraiser

- If the independent appraiser provides an opinion that the related party transactions would not comply with the arm's-length valuation rule, the appraiser must state their opinion on the alternative transaction terms that could enable compliance with the arm's-length valuation rule (ID clause 2.8.4(4))



Our independent appraiser expectations (7)

Reliance by the auditor on the independent report

- Our requirements do not preclude the independent auditor from relying on the independent report to form its assurance opinion if appropriate under the assurance standards
- The auditor will need to consider timing issues which could mean the assurance opinion needs to be issued before an independent report can be completed



Questions and discussion

- Audit questions
- Independent appraiser questions
- Technical questions on interpreting and applying the related party transactions rules
- Any other matters



Audit and appraiser questions (1)

Materiality (assurance opinion)

- The level of assurance reflected in the term “in all material respects” (auditor opinion):
 - We expect independent auditors to exercise professional judgement on materiality in accordance with their assurance standards – see paragraphs 4.35 to 4.45 of the reasons paper
 - We expect auditors to apply the concept of ‘materiality’ from auditing standard SAE 3100 and ISAE (NZ) 3000³

³ Standard on Assurance Engagements 3100 – Compliance Engagements issued by the External Reporting Board in October 2014 and incorporating amendments up to August 2014 and *International Standard on Assurance Engagements (New Zealand) 3000, Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, issued by the New Zealand Auditing and Assurance Standards Board of the External Reporting Board in July 2014



Audit and appraiser questions (2)

Materiality (appraiser opinion)

- The level of assurance reflected in the term “in all material respects” (appraiser opinion):
 - We expect the independent appraiser to apply a similar standard of materiality, although this may vary if the appointed person is a member of a different professional body from an independent auditor



Audit and appraiser questions (3)

Benchmarking for imperfect markets

- Whether there would be co-ordination on the benchmarking process between the Commission and regulated suppliers, such as sharing of information:
 - We do not see the Commission taking a co-ordination role on benchmarking
 - We expect to see the regulated supplier and their auditor coordinating on benchmarking and the assurance opinion
 - If the independent auditor reaches a modified opinion, it may result in the need to engage an independent appraiser for the more detailed independent report



Audit and appraiser questions (4)

Expenditure categories

- Separate representative examples of procurement policies are required where the policies are significantly different between expenditure categories (ID clause 2.3.12(5)):
 - We expect expenditure categories to be consistent with those used for other ID disclosures
 - Sub-categories may need to be considered if more than one procurement policy is used across one expenditure category
 - The idea is to get sufficient representative examples of all procurement policies that apply to material categories of expenditure



Audit and appraiser questions (5)

Level of detail on procurement processes and policies

- A summary of the procurement policy (or equivalent) needs to be disclosed (ID clause 2.3.10)
- A description of how the procurement policy is applied (ID clause 2.3.12(1)):
 - We expect this to include how staff responsibilities and purchasing controls are managed under the policy
 - We expect this to include a description of how maintenance and effectiveness of the policy is overseen under governance



Audit and appraiser questions (6)

Technical aspects of procurement processes and policies

- Level of detail on the reasons for using a related party:
 - We do not expect to give guidance on this, as the use of a related party is a commercial decision for the regulated supplier and the reasons will vary
 - We expect sufficient detail to be disclosed to enable ID stakeholders to identify the reasons for using the related party and the linkage or otherwise of that decision to the arm's-length valuation rule
 - We expect the auditor to evaluate whether those reasons are consistent with arm's-length transactions

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Audit and appraiser questions (7)

Technical aspects of procurement processes and policies (continued)

- Level of detail on how costs for related party transactions are set in practice between the parties:
 - We do not expect to give guidance on this, as the basis of establishing the transaction cost is a commercial decision for the regulated supplier
 - We expect sufficient detail to be disclosed to enable ID stakeholders to identify the basis and its linkage or otherwise to the arm's-length valuation rule
 - We expect the auditor to evaluate whether the basis for establishing costs between the parties is consistent with arm's-length transactions

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Audit and appraiser questions (8)

Technical aspects of procurement processes and policies (continued)

- Level of detail on how changes in the application of the procurement policy by the regulated supplier are applied between disclosure years:
 - We expect the auditor to evaluate the materiality of the change in the policy or its application with respect to the arm's-length valuation rule between the two years



Opportunity for discussion



Audit and appraiser references (1)

Reasons paper

- *Input methodologies review – related party transactions: Final decision and determinations guidance*, Commerce Commission, 21 December 2017

Input methodologies - commissioned assets

- *Electricity distribution services input methodologies amendments determination 2017* [2017] NZCC 30, 21 December 2017; clauses 2.2.11(5) & (6), 5.3.11(7) & (8)
- *Gas distribution services input methodologies amendments determination 2017* [2017] NZCC 31, 21 December 2017; clauses 2.2.11(5) & (6), 5.3.11(7) & (8)

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Audit and appraiser references (2)

- *Gas transmission services input methodologies amendments determination 2017* [2017] NZCC 30, 21 December 2017; clauses 2.2.11(5) & (6), 5.3.11(7) & (8)

Information disclosure requirements - EDBs

- *Electricity distribution information disclosure amendments determination 2017* [2017] NZCC 33, 21 December 2017; related party transactions, clauses 2.3.6 to 2.3.16; assurance reports, clauses 2.8.1(1)(d) & (2); independent report, clauses 2.8.2 to 2.8.5

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Audit and appraiser references (3)

Information disclosure requirements - GDBs

- *Gas distribution services input methodologies amendments determination 2017* [2017] NZCC 34, 21 December 2017; related party transactions, clauses 2.3.6 to 2.3.16; assurance reports, clause 2.8.1(1)(d) & (2); independent report, clauses 2.8.2 to 2.8.5

Information disclosure requirements - GTB

- *Gas transmission services input methodologies amendments determination 2017* [2017] NZCC 35, 21 December 2017; related party transactions, clauses 2.3.6 to 2.3.16; assurance reports, clause 2.8.1(1)(d) & (2); independent report, clauses 2.8.2 to 2.8.5



Audit and appraiser references (4)

Website link to related party transactions input methodology papers (copy to your browser)

<http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/related-party-transactions-provisions/>



Contact us

If you and your audit client cannot resolve issues with the new rules between you, please contact:

- Related party transactions ID audit assurance report or the independent report: grant.weston@comcom.govt.nz
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